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**COORDINATED ISSUE
CONSTRUCTION/REAL ESTATE INDUSTRY
CLAIM REVENUE UNDER A LONG-TERM CONTRACT**

ISSUE

Whether taxpayer must include "claim revenue" in the total contract price in determining the gross income from a long-term contract under I.R.C. § 460 for the taxable year at issue?

FACTS

Contractor, a calendar year taxpayer, enters into a "long-term contract" (as defined under section 460(f)) with a client for the building, installation, or construction of property on January 1, 1994 scheduled for completion in January of 1997. The contract does not involve home construction, and contractor's average annual gross receipts from 1992 through 1994 exceeded \$10,000,000.

In 1995, during the course of construction, contractor performed additional work and incurred additional costs attributable to customer caused delays, errors in specifications and designs, unpriced change orders, or other unanticipated work. The contractor deducted these costs for tax purposes. Although client agreed to the additional work, the parties had not agreed to a price for the extra work performed. The parties will negotiate the price at a later time.

In determining the amount of gross income from the contract under section 460 for its 1995 taxable year, the contractor used the original contract price in the section 460 computation. Contractor did not increase the total contract price, for purposes of section 460, for the revenue attributable to the additional work performed during 1995 ("claim revenue").

For book purposes, however, contractor accrued additional income attributable to the additional work performed in accordance with the Accounting Standards Division of the American Institute of Certified Public Accountants Statement of Position 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" Statement of Position 81-1 ("AICPA SOP 81-1"). Paragraph 65 of AICPA SOP 81-1 establishes a standard for revenue recognition for claims. Claims are defined as amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other

unanticipated additional cost. Recognition of additional contract revenue relating to claims is appropriate if the following conditions are met:

- a. The contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim;
- b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not a result of the contractor's performance;
- c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed; and
- d. The evidence supporting the claim is objective and verifiable, not based on management's feel for the situation or on unsupported representations.

Paragraph 66 of AICPA SOP 81-1 allows an alternative to the above in that the contractor may defer recording revenue from claims until they have been received or awarded. If the contractor defers recording claim income, the amounts should be disclosed in the financial statements.

DISCUSSION

Section 460(a) generally requires the determination of gross income from any long-term contract under the percentage of completion method of accounting of section 460(b) (the "PCM"). The PCM involves a two-step process. First, the taxpayer must annually determine the amount of gross income for each taxable year of the contract. I.R.C. § 460(b)(1)(A). Second, upon completing the contract, the taxpayer must compute the amount of look-back interest that is payable on hypothetical underpayments of tax, or receivable on hypothetical overpayments of tax, for each year during the life of the contract. I.R.C. § 460(b)(1)(B).

Under the PCM, the taxpayer must include in gross income in each taxable year ending after the date the contract is entered into an amount equal to the excess of (1) the product of (a) the total amount of revenue that the taxpayer estimates it will receive from the contract (the total contract price) and (b) the completion factor, over (2) the total cumulative amount of the contract revenue required to be included in gross income in all preceding taxable years. I.R.C. § 460(b)(1)(A); Notice 89-15, 1989-1 C.B. 634, 640 Q&A 19. The completion factor is equal to the ratio of the total cumulative amount of costs allocable to the contract incurred to date, to the total amount of costs allocable to the contract that the taxpayer expects to incur. I.R.C. § 460(b)(1)(A); Notice 89-15, 1989-1 C.B. at 641, Q&A 20. The costs allocable to the

contract are allowable as deductions from gross income in computing taxable income in the year in which such costs are incurred. Notice 89-15, 1989-1 C.B. at 642, Q&A 32.

Notice 89-15, 1989-1 C.B. 634, provides guidance for determining the amount that is treated as total contract price for purposes of applying the PCM. The total amount of revenue a taxpayer expects to receive from a long-term contract, i.e., the total contract price, is not a static amount. The amount may vary for each year of the contract. 1989-1 C.B. at 640, Q&A 19. As a general matter, amounts received or to be received by a taxpayer from a client as reimbursement for costs in performing a long-term contract are included in the total contract price. 1989-1 C.B. at 642, Q&A 31. A taxpayer must make a reasonable estimate of the total contract revenue it expects to receive from a long-term contract based on the facts available on the last day of each taxable year of that contract. 1989-1 C.B. at 641, Q&A 24.

The standard for determining whether and when claim revenue becomes part of the total contract price in any particular year of a long-term contract is based on a reasonable estimation of receipt not on when the taxpayer's rights to the additional revenue becomes fixed and determinable. See, Treas. Reg. § 1.460-6(c)(2)(vi)(A) (amounts are treated as part of the contract price as soon as it is reasonably estimated that they will be received even if the all events test has not been met). "[A] portion of the contract price that is in dispute is included in the total contract price at the time and to the extent that the taxpayer can reasonably expect the dispute will be resolved in the taxpayer's favor (without regard to when the taxpayer receives payment for the amount in dispute or when the dispute is finally resolved)." Treas. Reg. § 1.460-6(c)(2)(vi)(B). Thus, the total contract price includes any amount the taxpayer reasonably expects to receive from the client under the contract, or any other rule of law including the contract law of quantum meruit, and other quasi-contractual remedies. Notice 89-15, 1989-1 C.B. at 642, Q&A 27.

In this case, the contractor has underestimated the total contract revenue it expects to receive from the contract, i.e., the total contract price, in determining the amount of its gross income from the contract in 1995 by the amount of the claim revenue. The claim revenue is the amount of the additional revenue the contractor should have reasonably expected to collect on the contract from performing the additional work in 1995. In general, since expected quantum meruit recoveries are included in gross income, this amount should not be less than the contractor's cost of performing the additional work.

As a preliminary matter, the contractor incurred additional costs based on the client's authorization to perform the additional work. Although the parties did not discuss price, the contractor probably would not have performed the additional work if it knew or expected it would not be paid or reimbursed for at least its additional costs. See Notice 89-15, 1989-1 C.B. at 642 Q&A 31 (expected cost reimbursements included in total contract price). Further, even if the client had disputed the price, it would be highly

likely that the contractor would at least have recovered its costs under some express or implied contract theory of recovery. See Notice 89-15, 1989-1 C.B. at 641 Q&A 24 (total contract price includes amounts the taxpayer reasonably expects to receive under the contract and any other rule of law). Finally, the contractor accrued income for book purposes in 1995 equal to the amount of costs it incurred for the additional work in that year pursuant to AICPA SOP 81-1. Although strict financial conformity is not required for tax purposes, the taxpayer's accrual of revenue for financial reporting purposes attributable to the additional work authorized by the client strongly indicates that the taxpayer could reasonably estimate the amount of contract revenue to be received. The absence of accrued revenue, however, does not establish for tax purposes that the taxpayer could not reasonably estimate the amount contract revenue attributable to the additional work.

CONCLUSION

The facts here indicate that at the end of 1995, it was reasonable to conclude that the contractor would be paid for the additional work. The contractor must include "claim revenue" in the total contract price in determining the gross income from a long-term contract under section 460 for the taxable year at issue.